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February 28, 2005

James G. Daly
NSTAR Gas Company
One NSTAR Way
Westwood, MA 02090

RE: Petition of NSTAR Gas Company for approval of proposed changes to its gas procurement practices, D.T.E. 04-63.

Dear Mr. Daly:

On June 17, 2004, NSTAR Gas Company ("NSTAR" or "Company") filed a letter with the Department of Telecommunications and Energy ("Department") in which the Company requested Department authorization to implement a change in its gas purchasing practices designed to mitigate price volatility for its customers ("Company Letter"). On July 7, 2004, the Department issued a Notice for Comments. Comments were filed by the Office of the Attorney General ("Attorney General"), the Division of Energy Resources ("DOER") and Direct Energy Marketing, Inc. ("Direct Energy"). Joint comments were filed by the low-income weatherization and fuel assistance network, the Massachusetts Community Action Program Directors Association, Inc., and the Massachusetts Energy Directors Association (collectively "Low-Income Parties"). NSTAR also filed reply comments on August 31, 2004. The Department held a technical session on October 5, 2004.

Company's Proposal

In its letter, the Company states that currently it purchases approximately one-third of the gas volumes needed to meet peak-season customer requirements in roughly equal increments over a seven-month period from April through October, and these volumes are stored underground and in liquefied natural gas ("LNG") facilities until needed (Company

Letter at 1). The Company also states that the remainder of its gas supply needed to meet peak-season customer requirements is purchased at the time that the gas will be consumed based on "first-of-the-month" and "spot," or daily market pricing, both of which are generally based on published index prices (id.). NSTAR asserts that its storage purchases are less susceptible to market-price fluctuations because they are generally made in roughly equal amounts over a seven-month period and the cost of those purchases is blended together (id.). The Company further states that the costs of the storage purchases are charged to customers as the weighted average of prices available over the seven-month off-peak season (id.). The Company asserts that it could achieve a greater level of price volatility mitigation by purchasing an additional portion of its normal winter requirements over the preceding twelve-month period, similar to the purchasing approach for storage gas, rather than making daily or spot purchases (id. at 2).

Therefore, for the winter of 2005-06, the Company proposes to purchase approximately one-third of its projected normal winter requirement in twelve equal monthly purchases over a one-year period commencing after the Department's approval of the Company's proposal (id.). The Company states that the prices charged to customers through the Cost of Gas Adjustment Clause ("CGAC") in the peak period for the portion of gas purchased using this approach would equal the average price obtained by the Company for these supplies over the twelve-month purchasing period (id.). NSTAR states that this proposal combined with the purchase of gas for storage, would mitigate price volatility for two-thirds of the Company's peak period usage (id.). NSTAR contends that this purchasing approach benefits customers because the highest level of price volatility typically occurs during the winter months and coincides with cold weather and increased consumption by customers (id.). Because NSTAR would not be taking physical delivery of the gas when the monthly purchase is made, the Company proposes to accomplish these purchases through financial contracts that would lock in prices for designated volumes (id.). Under its proposal, NSTAR will enter into financial arrangements with large financial institutions, wherein the Company would agree to pay a fixed price for a fixed volume of gas at a point in the future (id.). The fixed price would be based on the New York Mercantile Exchange ("NYMEX") future prices for each month of the upcoming heating season at the time the agreement is executed (id.). The difference between the fixed price of gas and the actual market price of gas at the time of purchase would be reconciled between the Company and the financial institution (id.).

Attorney General's Comments

In his comments, the Attorney General argues that the Company has failed to demonstrate that the proposal would achieve greater gas price stability pursuant to the standards and criteria the Department established in Risk-Management Techniques to Mitigate Natural Gas Price Volatility, D.T.E. 01-100-A (2002) (Attorney General Comments at 3). The Attorney General argues that adjudicatory proceedings are necessary because, unlike the proposal that the Department approved in KeySpan Energy Delivery of New England, D.T.E. 03-85 (2003), NSTAR's proposal requires the use of financial derivatives (id.). The Attorney General contends that the Company's proposal does not provide enough information regarding the use of financial derivatives, and that the Department should therefore conduct an adjudicatory proceeding to further develop the record to address these issues (id.).

DOER's Comments

DOER states that overall it supports NSTAR's proposal (DOER Comments at 2).

Low-Income Parties' Comments

In their comments, the Low-Income Parties recommend that the Department further evaluate whether the Company's proposal meets the Department's standard of being reasonably designed to meet the objective of price stability (Low-Income Parties Comments at 3-5).

Direct Energy's Comments

Direct Energy asserts that, insofar as NSTAR's proposal involves financial derivatives, the Department should require the Company to provide further information regarding its plan and to demonstrate that the plan complies with the Department's standards set forth in D.T.E. 01-100-A (Direct Energy Comments at 1). Direct Energy further argues that the Department should reconsider its risk-management approach in general, and allow the competitive market to offer products and services which address volatility concerns (id. at 3).

Company's Reply Comments

On August 31, 2004, NSTAR filed reply comments addressing the concerns raised by the parties in their respective comments. In its reply comments, the Company asserts that there is no need for evidentiary hearings or further proceedings because its proposal is identical to the KeySpan Energy Delivery New England ("KeySpan") proposal that the Department approved in D.T.E. 03-85 (Company Reply Comments at 3). The Company argues that, as KeySpan proposed and received approval for in D.T.E. 03-85, it is merely locking in the price for non-storage supplies equaling one-third of its projected normal winter requirements over the preceding twelve-month period (id., citing D.T.E. 03-85, at 2). The Company further contends that its proposal is not different from KeySpan's simply because NSTAR uses financial contracts to lock in prices (id.). NSTAR argues that these financial contracts are "swap" arrangements[1] and are not financial derivatives because (1) the objective of the

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[1] A swap is a custom-tailored, individually negotiated transaction designed to manage financial risk. In a typical commodity or price swap, parties exchange payments based on changes in the price of a commodity or a market index, while fixing the price they effectively pay for the physical commodity. The transaction enables each party to manage exposure to commodity prices or index values (NYMEX website,

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arrangements is not to obtain prices below published averages, and (2) the Company will not incur transactional costs (id. at 4, citing D.T.E. 01-100-A at 6).

The Company also asserts that its proposal is consistent with the standards and criteria set forth by the Department because it is reasonably designed to meet the objective of price stability by averaging gas prices over a twelve-month period (id. at 5, citing D.T.E. 01-100-A). Specifically, the Company contends that, as proposed, the purchasing schedule for a portion of its winter commodity needs is merely shifted (id. at 5).

Analysis and Findings

The Department's standard of review requires that a local gas distribution company ("LDC") show that a risk management plan is reasonably designed to meet the objective of price stability. D.T.E. 01-100-A at 28. Before the Department will approve any risk management plan, said plan must meet six requirements. The first requirement is that customers be allowed to voluntarily participate in the program.[2] Id. We find that this directive is inapplicable because the Company's proposal does not involve a fixed-priced optional service for a subset of customers who are willing to pay a premium for that fixed price, therefore there is no danger of misallocation of costs.

The second requirement is that the plan maintain the goal of volatility mitigation and price stability rather than the objective of procuring prices below indices. D.T.E. 01-100-A at 28. Under its proposal, NSTAR would lock in prices on non-storage volumes at a rate of one-twelfth of the required volumes per month (Company Letter at 2). The Company states that it will base its purchases on NYMEX futures prices available each month (id.). Further, the Company's purchases under the proposed program are not tied to any performance indices (Company Reply Comments at 5). Given this information, the Department finds that the proposed purchasing strategy will limit the exposure of the Company's ratepayers to steep fluctuations in price. Therefore, the proposal meets the Department's second criterion to mitigate price volatility.

The third requirement is that the plan ensure fair competition in the gas supply market. D.T.E. 01-100-A at 29. The Department has stated that a financial risk-management program will not adversely affect gas unbundling and customer choice if it: (1) provides all customers with an opportunity to obtain more stable prices and costs are allocated only to those who

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[1](...continued)
http://www.nymex.com/jsp/index.jsp).

[2] The Department has stated that voluntary participation in risk-management programs is necessary because, "the costs associated with such a program shall be recovered from only the customers who choose to participate in the program." D.T.E. 01-100-A at 16.

participate in the program; and (2) does not impede efficient competition among all suppliers. Id. at 17. First, all of the Company's customers would benefit from the proposal because gas price volatility would be mitigated. Second, regarding efficient competition among suppliers, the Department has stated that risk-management programs will not negatively affect gas unbundling and customer choice if the recovery of costs by the LDC does not affect the reliability and transparency of the rates charged by the LDC. Id. at 16. Again, under the Company's proposal, there are no transaction costs to be recovered, so there is no effect on the reliability and transparency of rates. Accordingly, the Department finds that the proposal does not impede fair competition in the gas supply market.

The fourth requirement is that the Company allocate all costs of the risk-management program to program participants only. Id. at 29. There are no implementation costs associated with the program, hence there are no costs to allocate (Company Reply Comments at 6). Therefore, the fourth requirement is inapplicable.

The fifth requirement is that the Company demonstrate the effect of the plan on the reliability and transparency of commodity price. Id. The Company proposes to change its schedule for gas purchasing and not the pricing mechanism (Company Letter at 2). Because the same pricing indices that are currently used will continue to be used in the future, there will be no effect on the reliability and transparency of commodity price. Thus, the proposal meets the fifth requirement.

Finally, the sixth requirement is that the proposal contain no incentive mechanism. D.T.E. 01-100-A, at 29. No incentive mechanism has been proposed; consequently, the Company's proposal meets the sixth requirement.

In their comments, the Attorney General, DOER, Direct Energy and the Low-Income Parties request that the Department conduct evidentiary hearings on the Company's proposal (Attorney General's Comments at 2; DOER Comments at 3-4; Direct Energy Comments at 3; Low-Income Parties Comments at 1). These requests are based primarily on the commenters' concern with the use of financial derivatives. However, our discussion in D.T.E. 01-100-A as to the use of financial derivatives was in the context of risk-management plans that involved the application of these derivatives where the objective is to obtain prices below published averages and that such use requires the LDCs to pay transaction costs. D.T.E. 01-100-A at 5-6. In this case, the Company's approach is to purchase gas in equal increments across a twelve-month period, rather than purchase more gas during the winter months when the price is usually highest (Company Letter at 2). By doing so, price volatility is mitigated because a lesser amount of gas supply is purchased in any given month. NSTAR will enter into financial contracts to lock in future NYMEX prices, however, these contracts will not be used to obtain prices below published averages, nor will they cause NSTAR to incur transaction costs that are in excess of the available locked-in market price (id. at 4). Accordingly, under these circumstances, no further Department proceeding is warranted.

DOER and the Low-Income Parties also question whether NSTAR's gas purchasing program should be for longer than twelve months and should include more than one-third of the Company's projected normal winter requirements. The Department notes that NSTAR has taken a conservative approach in price volatility mitigation. By limiting the winter gas requirement that it will include in the fixed-price program, NSTAR can assess its ability to stabilize prices while still obtaining a portion of its gas requirements at variable prices. Also purchasing over a twelve-month period is consistent with the Company's current program for storage gas purchases. Thus, the Department finds that NSTAR's gas purchasing program is a reasonable initial step in an attempt to stabilize prices. As the Company assesses the results of its program, the Department would encourage the Company to propose modifications to its program.

Finally, Direct Energy recommends that the Department reconsider its risk-management approach and allow the competitive market to offer products and services to address volatility concerns (Direct Energy Comments at 3). The Department's policy on the use of risk-management techniques to mitigate natural gas price volatility was enunciated in D.T.E. 01-100-A. Direct Energy's request goes beyond the scope of what the Company is proposing in this proceeding and would preclude the Company from commencing its proposal promptly. Such a delay would be detrimental to customers. Therefore, we decline to take such action.

Accordingly, for the reasons outlined above, the Department finds that NSTAR has shown that the plan is reasonably designed to meet the objective of price stability. Therefore, the Department approves NSTAR's gas procurement and volatility mitigation plan. However, as part of its seasonal CGAC filings, the Company must include the following information for all purchases made as part of its volatility mitigation plan: the volumes, indices, contracted price, and delivery date.

By Order of the Department,

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Paul G. Afonso, Chairman

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James Connelly, Commissioner

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W. Robert Keating, Commissioner

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Judith F. Judson, Commissioner

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Brian Paul Golden, Commissioner